

REPORT OF EXAMINATION
OF THE
BLUE SHIELD OF CALIFORNIA LIFE & HEALTH
INSURANCE COMPANY

AS OF
DECEMBER 31, 2008

Filed: May 24, 2010

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San Francisco, California
March 25, 2010

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

BLUE SHIELD OF CALIFORNIA LIFE & HEALTH INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office, located at 50 Beale Street, San Francisco, California 94105.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2004. This examination covers the period from January 1, 2005 through December 31, 2008. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2008, as deemed necessary under the circumstances. The examination was conducted concurrently with the examination of the Company's affiliate, CareAmerica Life Insurance Company.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

SUBSEQUENT EVENTS

For the year ended December 31, 2009, the Company continued to experience significant growth in the accident and health lines of business. In addition, the Company experienced a \$96.6 million operating loss from operations. These factors combined to drive the risk-based capital percentage below the target created by the Company's management. As a result, the Company received capital contributions from its parent, Blue Shield of California (BSC), in March and December 2009, that totaled \$170.2 million. The contributions were made in the form of cash and a reduction to inter-company payable that was owe to BSC.

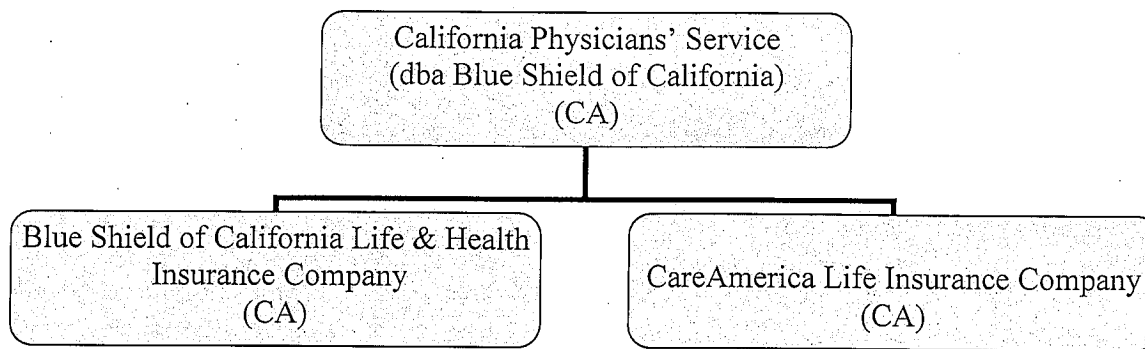
COMPANY HISTORY

The Company paid an extraordinary dividend to its parent company, Blue Shield of California (BSC) in two payments during 2007. The first payment of \$40.1 million was paid on April 26, 2007 and the second payment of \$42.4 million was paid on November 19, 2007 for a total distribution of \$82.5 million. The Company submitted an application for the extraordinary dividend with the California Department of Insurance per California Insurance Code (CIC) Section 1215.5(g) and received approval on February 22, 2007.

In 2008, the Company received a cash contribution from its parent, BSC, in the amount of \$30 million.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which California Physicians' Service (d.b.a. Blue Shield of California) is the ultimate controlling entity. The following organizational chart depicts the relationships of the companies within this holding company system as of December 31, 2008 (all ownership is 100%):



Management of the Company is vested in an eleven-member board of directors elected annually. As of December 31, 2008, the directors and principal officers were as follows:

Directors

Name and Residence

Principal Business Affiliation

Bruce G. Bodaken
Mill Valley, California

Chairman, President, and Chief Executive
Officer
California Physicians' Service

Douglas Busch
Penryn, California

Vice President and Chief Technology
Officer
Intel Corporation's Digital Health Group

Vanessa C. L. Chang
Los Angeles, California

Principal
EL & EL Investments

William Hauck
Sacramento, California

President
California Business Roundtable

Sandra Hernandez, M.D.
San Francisco, California

Chief Executive Officer
The San Francisco Foundation

Robert Lee
Moraga, California

Retired
Former President of Pacific Bell

Thomas L. Lee
Newhall, California

Retired
Former Chairman and Chief Executive
Officer of The Newhall Land and
Farming Company

Name and ResidencePrincipal Business Affiliation

Aliza Lifshitz, M.D.*
Los Angeles, California

Medical Doctor
Cedars-Sinai Medical Center

Thomas V. McKernan*
Arcadia, California

Chief Executive Officer
Automobile Club of Southern California

Leon E. Panetta**
Carmel Valley, California

Co-founder and Director
Leon and Sylvia Panetta Institute of Public
Policy

Robert A. Reid, M.D.*
Santa Barbara, California

Director of Medical Affairs
Cottage Hospital

**Resigned from the Board on October 31, 2009. Evelyn Dilsaver, Hector Flores, M.D., and Alan Fohrer were elected to the Board on November 1, 2009.*

***Resigned from the Board on February 2, 2009.*

Principal OfficersNameTitle

Duncan Ross
Emily R. Glidden
Seth A. Jacobs, Esq.
Christopher Gorecki
Andrea DeBerry

President and Chief Executive Officer
Treasurer
Secretary
Controller
Assistant Secretary

Intercompany Agreements

Effective October 1, 2003, the Company entered into an administrative services agreement with its parent, Blue Shield of California (BSC). Under the terms of the agreement, BSC provides the Company with personnel, facilities, information systems, administrative and operations support. Operations support includes, but is not limited to, actuarial, underwriting, premium billing and collection, claim processing, sales and marketing and various other services. The California Department of Insurance (CDI) approved this agreement on September 13, 2004. The agreement was revised twice, with each revision submitted to and approved by the CDI on August 17, 2004

and December 27, 2005, respectively, in accordance with the California Insurance Code Section 1215.5 (b)(4). A third amendment was filed with the CDI in December 2009, and is currently being reviewed. During the examination period, administrative expense reimbursements paid to BSC were as follows: \$41,352,639 in 2005; \$68,791,337 in 2006; \$112,005,126 in 2007; and \$174,028,642 in 2008.

Effective January 1, 1987, the Company entered into a tax allocation agreement with its parent, BSC, for the purpose of filing a consolidated federal income tax return. Under the terms of the agreement, each company's regular or alternative minimum tax liability is calculated separately and adjusted for its share of specified consolidated items of income and deductions.

CORPORATE RECORDS

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in the form first formally prepared by the examiners and in the form as finally settled and officially filed by the commissioner. The board must also enter that fact in the board minutes. A review of the board minutes failed to provide any statements pertaining to the receipt of the examination report.

It is recommended that the Company implement procedures to ensure compliance with CIC Section 735.

TERRITORY AND PLAN OF OPERATION

The Company is licensed and operates exclusively in the State of California. It is authorized to write disability and life. Direct written premiums during 2008 were \$773.8 million. Of the \$773.8 million in direct written premiums, group accident and health accounted for 57.9%, other accident and health 40.8%, group life 1.1%, and ordinary life 0.2%.

The Company has no direct employees. Employees of Blue Shield of California (BSC), the Company's parent, manage the affairs of the Company.

Business is produced through approximately 17,000 independent agents and brokers, who are also sales representatives for BSC. These agents and brokers are paid commissions ranging from 0.375% to 15% for group coverage, 15% to 20% for new individual life policies, and 7% to 10% for renewals. The Company also sells its individual products through BSC's telemarketing direct sales unit and the internet.

REINSURANCE

Assumed

The Company had multiple quota share reinsurance agreements with United HealthCare Insurance Company effective January 1, 2003. These agreements were terminated effective September 30, 2005 under the Novation Agreement Endorsement (Agreement) and transferred to an affiliate, CareAmerica Life Insurance Company, because of Blue Cross Blue Shield Association rules and regulations that prohibit the Company from transacting business in other states. The Agreement was approved by the CDI on December 16, 2004, pursuant to California Insurance Code Section 1011(c).

Ceded

The following table is an outline of the Company's ceded reinsurance program as of December 31, 2008:

Type of Contract	Reinsurer's Name (All Authorized)	Company's Retention	Reinsurer's Maximum Limits
LIFE REINSURANCE			
Excess Life and AD&D Automatic Group	Swiss Re Life & Health America Inc.	For Group Life: \$150,000 per person For Group AD&D: \$150,000 per person	For Group Life: 100% excess of \$150,000 up to a maximum of \$1 million per person For Group AD&D: 100% excess of \$150,000 up to a maximum of \$1 million per person
Catastrophe Life/AD&D	Swiss Re Life & Health America Inc.	\$2 million per accident	Up to a maximum of \$10 million per accident; \$20 million in any agreement year, subject to one reinstatement
Quota Share Group Term Life – EDS Employees	Swiss Re Life & Health America Inc.	Employee/Retiree: 50% of the first \$100,000; 10% of the next \$1 million Spouse/Dependent: 50% of the first \$200,000	Employee/Retiree: 50% of the first \$100,000; 90% of the next \$1 million Spouse/Dependent: 50% of the first \$200,000
Voluntary AD&D	Swiss Re Life & Health America Inc.	25% of \$250,000 any one life	75% of \$250,000 any one life
ACCIDENT AND HEALTH REINSURANCE			
Quota Share Specific Stop Loss	Standard Security Life Insurance Company of New York*	40% of first \$1 million net loss per covered person per policy period in excess of the specific deductible amount	60% of first \$1 million net loss per covered person per policy period in excess of the specific deductible amount
Quota Share Aggregate Stop Loss	Standard Security Life Insurance Company of New York*	40% of first \$1 million net loss in aggregate, any one original plan, per policy period	60% of first \$1 million net loss in aggregate, any one original plan, per policy period

Type of Contract	Reinsurer's Name (All Authorized)	Company's Retention	Reinsurer's Maximum Limits
Excess Specific Stop Loss	Standard Security Life Insurance Company of New York*	\$1 million	100% of all liability \$5 million in excess of \$1 million up to a maximum issue limit of \$6 million per covered person per policy period in excess of the specific deductible amount
Excess Aggregate Stop Loss	Standard Security Life Insurance Company of New York*		Liability for aggregate policy limits in excess of \$1 million any one original plan per policy period is priced and underwritten facultatively by the reinsurer
Quota Share	Lincoln National Life Insurance Company**	50% of long term care insurance benefits	50% of long term care insurance benefits

**Effective August 30, 2009, all treaties with Standard Security Life Insurance Company of New York were cancelled and replaced with a new agreement with Zurich American Insurance Company, effective September 1, 2009.*

***As of September 1, 2009, the Company, Lincoln National Life Insurance Company (LNL), and Swiss Re Life & Health America, Inc. (SRLHA), entered into a Novation Agreement whereby LNL transferred and assigned the Reinsurance Agreement and all of LNL's rights, duties, obligations, and liabilities to SRLHA.*

ACCOUNTS AND RECORDS

A review was made of the Company's general controls over its information systems. As a result of the review, some control deficiencies were noted in areas such as user access, change management, and logical security. The control deficiencies noted were presented to the Company along with recommendations to strengthen its controls in these areas. The Company should evaluate the recommendations and make appropriate changes to strengthen its information system controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2008

Summary of Operations and Capital and Surplus Account for the Year Ended
December 31, 2008

Reconciliation of Surplus as Regards Policyholders from December 31, 2004
through December 31, 2008

Statement of Financial Condition
as of December 31, 2008

	<u>Ledger and Non-ledger Assets</u>	<u>Non- Admitted Assets</u>	<u>Net Admitted Assets</u>	<u>Note</u>
<u>Assets</u>				
Bonds	\$ 242,201,968		\$ 242,201,968	
Cash and short-term investments	66,062,927		66,062,927	
Contract loans	19,644		19,644	
Receivables for securities	1,188,442		1,188,442	
Investment income due and accrued	2,268,834		2,268,834	
Uncollected premiums and agents' balances in the course of collection	5,914,977	169,333	5,745,644	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	10,468		10,468	
Amounts recoverable from reinsurers	519,436		519,436	
Other amounts receivable under reinsurance contracts	183,515		183,515	
Amounts recoverable relating to uninsured plans	39,090		39,090	
Current federal and foreign income tax recoverable and interest thereon	5,912,006		5,912,006	
Net deferred tax asset	<u>4,059,497</u>	<u>3,883,148</u>	<u>176,349</u>	
Total assets	<u>\$ 328,380,804</u>	<u>\$ 4,052,481</u>	<u>\$ 324,328,323</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Aggregate reserve for life contracts			\$ 4,112,311	(1)
Aggregate reserve for accident and health contracts			4,669,541	(1)
Liability for deposit-type contracts			22,712	
Contract claims:				
Life			2,149,277	(1)
Accident and health			110,032,073	(1)
Premiums and annuity considerations for life and accident and health contracts received in advance			39,578,767	
Other amounts payable on reinsurance			1,436,705	
Interest maintenance reserve			1,498,519	
Commissions to agents due and accrued			1,196,586	
General expenses due or accrued			2,478,532	
Taxes, licenses and fees due or accrued			6,838,082	
Remittances and items not allocated			7,024	
Payable to parent, subsidiaries and affiliates			1,663,515	
Payable for securities			10,064,706	
Aggregate write-ins for liabilities			<u>93,085</u>	
Total liabilities			185,841,435	
Common capital stock		\$ 2,500,000		
Gross paid-in and contributed surplus		31,910,000		
Unassigned funds		<u>104,076,888</u>		
Capital and surplus			<u>138,486,888</u>	
Total liabilities, capital and surplus			<u>\$ 324,328,323</u>	

Summary of Operations and Capital and Surplus Account
for the Year Ended December 31, 2008

Summary of Operations

Premiums and annuity considerations	\$750,525,158
Net investment income	11,180,832
Amortization of interest maintenance reserve	279,475
Commissions and expenses allowances on reinsurance ceded	<u>1,430,277</u>
Total	<u>763,415,742</u>
Death benefits	3,443,985
Disability benefits and benefits under accident and health contracts	562,644,933
Increase in aggregate reserves for life and accident and health contracts	(137,464)
Commissions on premiums, annuity considerations, and deposit-type contract funds	56,791,255
General insurance expenses	122,792,974
Insurance taxes, licenses and fees, excluding federal income taxes	<u>12,821,068</u>
Total	<u>758,356,751</u>
Net gain from operations before federal income taxes	5,058,991
Federal income taxes incurred	<u>368,781</u>
Net gain from operations after federal income taxes	4,690,210
Net realized capital losses	<u>(1,723,013)</u>
Net income	<u>\$ 2,967,197</u>

Capital and Surplus Account

Capital and surplus, December 31, 2007	<u>\$105,443,764</u>
Net income	2,967,197
Change in net unrealized capital losses	(43,304)
Change in net deferred income tax	1,549,839
Change in nonadmitted assets	(1,940,047)
Change in asset valuation reserve	509,439
Surplus adjustment: Paid in	<u>30,000,000</u>
Net change in capital and surplus for the year	<u>33,043,124</u>
Capital and surplus, December 31, 2008	<u>\$138,486,888</u>

Reconciliation of Capital and Surplus
from December 31, 2004 through December 31, 2008

Capital and surplus, December 31, 2004,
per Examination

\$ 119,582,194

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>
Net income	\$ 71,252,375	\$
Change in net unrealized capital losses		43,304
Change in net deferred income tax	3,997,542	
Change in nonadmitted assets		4,019,104
Change in asset valuation reserve	217,185	
Surplus paid-in	30,000,000	
Dividends to stockholders		<u>82,500,000</u>
Totals	<u>\$105,467,102</u>	<u>\$ 86,562,408</u>

Net increase in surplus as regards policyholders

18,904,694

Surplus as regards policyholders, December 31, 2008,
per Examination

\$ 138,486,888

COMMENTS ON FINANCIAL STATEMENT ITEMS

- (1) Aggregate Reserve for Life Contracts
Aggregate Reserve for Accident and Health Contracts
Contract Claims: Life
Contract Claims: Accident and Health

A Life Actuary from the California Department of Insurance performed an actuarial review of the reserves for the above liability accounts. Based on the work performed, the Company's December 31, 2008 reserves were found to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Corporate Records (Page 5): It is recommended that the Company implement procedures to ensure future compliance with California Insurance Code Section 735.

Accounts and Records (Page 8): It is recommended that the Company evaluate the recommendations from the information systems review and make appropriate changes to strengthen its information system controls.

Prior Report of Examination

Reinsurance - Ceded (Page 6): It was recommended that the insolvency and/or offset clause of the ceded reinsurance agreements with Swiss Re Life & Health America Inc. and Standard Security Life Insurance Company of New York be amended to comply with the requirements of California Insurance Code Section 922.2 in order for the Company to receive reinsurance credit in its future Annual Statements. The Company is now in compliance.

Accounts and Records (Page 8): It was recommended that the Company comply with the National Association of Insurance Commissioners' Annual Statement instructions. It was also recommended the Company evaluate the recommendations from the information systems review and make appropriate changes to strengthen its information system controls. The Company implemented most of the recommendations where appropriate and cost-effective. The current examination has developed new recommendations for the Company to strengthen its controls over its information systems.

Comments on Financial Statement Items - Aggregate Reserve for Life Contracts (Page 13); Aggregate Reserve for Accident and Health Contracts (Page 13); Contract Claims: Life and Accident and Health (Page 13): It was recommended that the Company (1) refine its method of computing its incurred but not reported waiver of premium reserve more frequently in the future, (2) put in place a more formal process to ascertain the need for a premium deficiency reserve, (3) maintain complete and accurate records on losses paid by the insured on stop loss policies that did not exceed their deductible amounts. The Company is now in compliance.

ACKNOWLEDGEMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and Blue Shield of California's employees during the course of this examination.

Respectfully submitted,

/s/

Kyo Chu, CFE
Examiner-in-Charge
Senior Insurance Examiner
Department of Insurance
State of California